September 12, 1996

VIA Hand Delivery

Docket Office
California Public Utilities Commission
505 Van Ness Avenue, Room 2001
San Francisco, California 94102

Re: R.94-04-031/I.94-04-032

Dear Docket Clerk:

Enclosed for filing in the above-entitled matter are the original and five copies of the **COMMENTS OF THE CALIFORNIA ENERGY COMMISSION IN RESPONSE TO THE RATESETTING WORKING GROUP UNBUNDLING REPORT**. Please return the extra copy in the enclosed, stamped, self-addressed envelope. Thank you for your attention to this matter.

Very truly yours,

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Enclosures

cc: ALJ Steven Weissman (via hand delivery)
Miriam Ebke, CACD (via hand delivery)
Restructuring Service List

BEFORE THE CALIFORNIA PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA

Order Instituting Rulemaking The Commission's Proposed Policies Governing Restructuring California's Electric Services Industry and Reforming Regulation	)))))	R.94-04-031 (Filed April 20, 1994)
Order Instituting Investigation on the Commission Proposed Policies Governing Restructuring California Electric Services Industry and Reforming Regulation	)))))	I.94-04-032 (Filed April 20, 1994)

COMMENTS OF THE CALIFORNIA ENERGY COMMISSION
IN RESPONSE TO THE RATESETTING WORKING GROUP
UNBUNDLING REPORT

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I. INTRODUCTION AND OVERVIEW

In accordance with the August 14, 1996 Assigned Commissioner Ruling (ACR), the California Energy Commission (CEC) hereby submits its comments in response to the August 26, 1996 Ratesetting Working Group Unbundling Report ("Unbundling Report"). In summary, the Unbundling Report identifies five "consensus items" that all participants agree must be unbundled, are necessary for implementation of Direct Access and must be in place on or before January 1, 1998. These items, referred to as Track 1 items, are: Generation, Transmission, Distribution, the Competition Transition Charge (CTC), and Public Goods charges. The CEC agrees that it is essential to unbundle these five consensus items.

The Working Group participants could not agree on the extent to which it is necessary or appropriate to unbundle goods and services that are components of the distribution function. The CEC's position remains that it is essential to unbundle the distribution function into its component services and that this process must begin now. By "unbundling," the CEC refers to the identification and separation of particular services and their costs. Unbundling does not, by itself, require that each unbundled component service be subject to competitive supply.

The CEC expects that many of the unbundled services will, in time, be supplied competitively. However, the CEC has concluded that unbundling must be accomplished first in a manner that will permit market participants to determine which component services can appropriately be supplied competitively. This process should begin now in order to maximize consumer choice in as many products and services that should be supplied by competitive markets in accordance with the public interest. Moreover this process must be linked with the development of the performance-based ratemaking methodology (PBR). These requirements are in conformity with the CEC's vision for consumer choice set forth in Chapter 2, of the November 1995, CEC Electricity Report.

The CEC Staff proposal, identified as Option 4, includes these features. The CEC hereby endorses the CEC Staff proposal and urges the California Public Utilities Commission (CPUC) to adopt the recommendations of Option 4. The CEC believes that the most essential features of Options 3 and 5 are contained within the scope of Option 4. By taking this option, the CPUC will be able to pursue distribution function unbundling through a process that will determine the extent to which competitive supply of each distribution function component service is in the public interest.

Below, we describe the main features of the five options included in the Unbundling Report and discuss the virtues justifying CEC endorsement of Option 4. We then critique Options 1 and 2 and conclude with an analysis of AB 1890 that supports implementation of Option 4.

II. SUMMARY OF THE UNBUNDLING REPORT

The Unbundling Report reflects the lack of consensus among the participants of the Ratesetting Working Group concerning the directives of the CPUC to investigate the unbundling of distribution services set forth in the Final Policy Decision, D.95-12-063, and the Roadmap Decision, D.96-03-022. Commissioner Duque in his June 12, 1996 ACR, requested the parties to identify "Track 1" items, which were defined as those items "that are necessary for the implementation of direct access and must be in place on or before January 1, 1998." As noted above, the participants reached consensus on five items: Generation, Transmission, Distribution, the Competition Transition Charge (CTC), and Public Goods charges. Track 2 items are those items that are "desirable but not necessary for direct access implementation."

Five options emerged and are included in the Unbundling Report. Southern California Edison Company (Edison) sponsored Option 1 which recommends that only the five

consensus items be unbundled and that consideration of any further unbundling be delayed until sometime after January 1, 1998.

Pacific Gas & Electric Company (PG&E), sponsor of Option 2, agrees with Edison that only the five consensus items are Track 1 items, but recommends that the analytic process for identifying Track 2 items begin now. Unbundling Report, Appendix 2-1 (quoting ACR of June 21, 1996).

San Diego Gas & Electric Company (SDG&E) offered Option 3. Option 3 identifies additional Track 1 items, characterizing them as essential distribution services: "metering, billing, customer and collection services." Unbundling Report, Appendix 3-1.

The CEC Staff sponsored Option 4. Option 4 calls for a comprehensive distribution unbundling process to begin now, both for the purpose of identifying additional products and services that could be provided by competitive markets, but also to offer a range of service options for items that remain monopoly services. The CEC Staff believe that the process it proposes could reveal additional Track 1 products and services necessary for implementation of direct access. However, the central emphasis of the CEC Staff proposal is for a methodologically sound unbundling process, beginning now and extending to and beyond January 1, 1998, that advances the CEC's vision of customer choice.

Finally, Option 5 is a jointly sponsored proposal offered by Agland Energy Services, Inc., Illinova Energy Partners, the School Project for Utility Rate Reductions, the Regional Energy Management Coalition and SharePlus. This group maintains that extensive unbundling beyond the five consensus items (along with a new method for financing and compensating the monopoly distribution functions that remain after extensive unbundling) is critical to ensure that the benefits of competition are not limited to large energy users. Option 5 proponents claim that if unbundling is limited solely to the commodity of generation, only transactions involving large quantities of

energy will be profitable enough to attract suppliers and marketers willing to compete with the utilities to serve large energy users. Option 5 urges that the distribution function be unbundled in advance of January 1, 1998.

III. THE CEC ENDORSES OPTION 4

The CEC endorses the CEC Staff proposal because Option 4:

- draws an important distinction between unbundling of component services, on the one hand, and competitive supply of unbundled component services, on the other hand. Unbundling does not require the competitive supply of the unbundled services. The policy decision to allow competitive supply of particular services can, and should, follow the unbundling;

- calls for unbundling to begin now, consistent with the strong support for unbundling among a substantial number of the working group participants;

- recognizes the need to develop a sound methodology for unbundling that will link the pricing of distribution services provided by the regulated monopoly to the PBR methodology;

- permits unbundling to begin using data from existing cost of service studies, but allows utilities to develop new data that could be substituted for the existing data upon a showing of public interest benefit;

- draws on aspects of unbundling and related issues that have already been investigated by the Direct Access Working Group and documented in its report submitted on August 30, 1996; and

- is consistent with the goals of AB 1890 to implement Direct Access by January 1, 1998.

Each of these points is discussed in detail below.

A. Distinguishing Between Unbundling and Competitive Supply of Unbundled Services

The description of Option 4 in the Unbundling Report attempts to clarify an important distinction between unbundling and competitive supply of unbundled component services. The following three points summarize the essence of this distinction:

1. Unbundling should be understood as referring to the separation of individual component services;

2. Competitive supply of unbundled component services is the provision of a separated component service by multiple suppliers, which might also include the regulated monopoly utility distribution company (UDC);

3. Unbundling is necessary in order to create competitive markets for individual component services. However, the value of unbundling is not limited to the ultimate goal of making each component service available on a competitive basis. Unbundled services that are only available from the regulated monopoly UDC may have significant value in the market place.

Unbundled services supplied exclusively by the monopoly UDC may service two different markets. First, end-use customers may be interested differentiated levels of specific service (e.g., different power quality features or dual service connections to increase distribution reliability), and be willing to pay accordingly. Second, private energy service providers may wish to arrange to have the UDC perform certain

services as the most efficient way to interface with customers, (e.g. the revenue cycle services). The latter would be classified as "intermediate goods," which may be unimportant to the end-use customer, but may be vital to potential private direct access providers. Potential direct access providers who are concerned that it will not be profitable to serve residential and small commercial customers, may benefit from unbundled supply of "intermediate services," such as the revenue cycle services described by SDG&E in Option 3.

For example, energy suppliers will require revenues from their customers. The UDC could provide unbundled billing services to such suppliers in lieu of the energy suppliers developing their own billing capability. These billing services could take many forms, ranging from "plain vanilla" bills where the charges of the energy supplier are a line item on a UDC consolidated bill, to "customized" bills in which the appearance of the bill and its presentation of details is designed expressly for the supplier. The energy supplier would be charged for these services, with greater charges for greater departures from the "normal" bill. More importantly, the energy supplier would not need to invest in duplicative billing capability and the consumer would not have to pay twice for billing services.

If there are services beyond the generation component, which must be unbundled by January 1, 1998, they are likely to be these intermediate services. These services should be unbundled, and probably could be unbundled in advance of January 1, 1998. The policy decision to permit these services to be supplied by competitive providers can come at a later date.

B. Common Support for Unbundling

A substantial number of participants of the Ratesetting Working Group support unbundling. This is reflected in the many common features of Options 3, 4 and 5. (It

should also be noted that Option 2 recommends that the unbundling process to identify Track 2 services begin now.) Option 3, 4 and 5 each call upon the CPUC to:

1. confirm the policy commitment for distribution function component service unbundling;

2. initiate an unbundling process now that may result in some unbundling prior to January 1, 1998, but will result in some unbundling by a date certain within a reasonable time after January 1, 1998;

3. establish a methodology for unbundling costs, determining prices of component services, and guiding policy decisions to permit competitive supply of unbundled component services; and

4. commit to applying the methodology to assess the full range of distribution function component services, with the intention of unbundling and opening to competition as many component services as the methodology suggests will have net societal benefits.

Due to differing interpretations of statements in the Final Policy Decision, D.95-12-063, and the Roadmap Decision, D.96-03-022, that relate to unbundling, it is critical that the CPUC resolve existing ambiguity by confirming the importance of distribution function unbundling as a policy decision. Decisions to allow competitive supply of unbundled services should be the subject of future policy decisions.

C. Development of an Integrated Methodology for Unbundling and Competitive Supply of Component Services

In working group discussion, parties have just begun to discuss the methodology that would be used to guide decisions on: unbundling; permitting competitive supply of some unbundled services; allowing the regulated monopoly to provide services which

are competitive; pricing of services by the regulated monopoly; and the PBR incentive framework that provides guidance to the regulated monopoly. Option 4 provides a framework which specifies how these various elements should be integrated, but requires much elaboration before it can be implemented.

SDG&E's July 15, 1996 filing with the CPUC provides the most complete description of such a methodology, but it falls short of the specificity and breadth called for by Option 4. The sponsors of Option 5, on the other hand, urge revolutionary change from the present utility structure that goes far beyond what the CPUC has described in D.95-12-063 or implied in D.96-03-022. However, Option 5 provides merely a sketch of how to get from here to there.

The CEC believes there are a substantial number of features of Option 3 and Option 5 which are compatible with Option 4. Others are not. SDG&E's approach assumes either competitive or monopoly supply of a component service is needed to determine how incremental or average costs are to be used as the basis for pricing. In Option 4, component services can be unbundled and priced independently of whether they will ultimately be provided through competitive markets. In fact, we believe that "testing the waters" through unbundling will determine whether there is a combination of customer interest and supply profitability that lead to a viable competitive market for a given service. Despite these differences, we believe that the sponsors of Options 3 through 5 share an interest in understanding common activities, developing attributable costs, creating mechanisms for flexibility in pricing, and other ingredients of a sound methodology for unbundling, competitive supply, and pricing of services. We expect that all parties working together can, in fact, develop an appropriate methodology that will accomplish unbundling and competitive supply of distribution component services. Like SDG&E, the CEC believes that this methodology can only be developed through a commitment to implement unbundling beginning now.

D. Development of a Methodology for Pricing Unbundled Services Linked with Regulated Monopoly PBR

The CEC believes that a methodology must be developed that integrates unbundling, competitive supply of component services, pricing of services provided by the monopoly, and PBR for the monopoly. Traditional PBR presumes a fixed, unchanging responsibility for the regulated utility, while unbundling and competitive supply lead to revised scope of service and changes in quality of service. Traditional PBR assumes base revenues can escalate with inflation and decline with a productivity index, while shifting component services from monopoly to competitive status should reduce base revenues by the cost of the service that has been shifted. Traditional PBR measures services in ways that presume no changes in quality of service and attempts to value levels of satisfaction. What is needed is a mechanism that recognizes that service quality offerings should evolve in response to customer choice. As the framework which provides the incentives to the UDC to reduce costs and yet continue to provide appropriate quality of service, PBR needs a strong link to an ongoing process of unbundling and competitive supply of some component services.

Option 4 proposes that a PBR mechanism be developed that provides appropriate incentives for the monopoly regulated UDC that also provides competitive services. The PBR mechanism should pursue several objectives. First, it should provide incentives to the UDC to lower costs of the monopoly provided services without sacrificing the quality of these services. Second, it should attempt to streamline the regulatory process itself.

Third, since the same firm will provide both monopoly and competitive services, the PBR mechanism should be designed to prevent cross-subsidization of the competitive segment by shifting costs to the monopoly segment. If such a possibility or incentive exists, the utility could charge prices for services in the competitive segment that are below their marginal cost. Losses that would otherwise have accrued from charging

anti-competitive prices in the competitive segment could then be shifted to the monopoly segment and recovered there.

Fourth, the unbundling and pricing of services cannot be considered separately and apart from PBR incentive mechanism for those services that will remain distribution monopoly services. The physical characteristics and economics of electricity distribution pose special challenges to the design of a PBR mechanism with the right kind of incentives. For example, the costs associated with electricity distribution are either constant, customer-related, or capacity-related. In this case, prices should be defined for distribution services and the distinction between a revenue-cap and a price-cap mechanism should be investigated with respect to the incentives they create.

E. Cost of Service Studies to Support Unbundling

The Road Map decision, D.96-03-022, directed utilities to file proposals for cost of service studies on July 15, 1996. Commissioner Duque's ACR of June 21, 1996, which postponed some elements and revised the nature of other elements originally due on July 15, appears to have inadvertently dropped the requirement that utilities propose cost of service studies. The CEC maintains that cost studies are necessary, but can be delayed.

Any valid methodology to review distribution function component services must have the benefit of data to identify costs of unbundled component services, either for reducing base rate revenues for PBR mechanisms or developing prices for individual component services. It would be ideal to have new studies of costing and pricing that would be designed specifically to address the many questions of distribution function unbundling. However, the absence of the results of these as-yet-unperformed cost of service studies does not mean that distribution function unbundling cannot proceed. It does mean, however, that care needs to be taken in the use of these existing data for

purposes of establishing either fixed prices or floor/cap ranges within which the UDC has pricing flexibility.

For example, since the total costs of the distribution function are reasonably well known, one might suppose that cost of service studies would provide a basis for allocating known costs to specific component services. However, there are numerous common costs of activities supporting two or more component services with little or no data to determine how or whether a cost allocation should be made. SDG&E raises the notion of using incremental attributable costs for those services for which the UDC remains a default provider, but using average attributable costs when the service is competitive. Further, economic theory provides minimal guidance so policy judgments will be required. The issue of whether attributable costs should be incremental or average may not be as simple as whether the component service is provided on a default basis or through markets in which the UDC is a competitor. These issues need to be resolved in advance of new cost and pricing studies to ensure the proper data are collected.

At this point in time, implementation of direct access by January 1, 1998, would be at risk if the CPUC were to order utilities to submit cost of service proposals, to review and adopt specific methodologies for these studies, to conduct the studies, and to analyze the results into unbundling proposals in advance of implementation of direct access. Therefore, the CPUC should direct utilities to pursue two parallel courses:

1. distribution function unbundling should proceed with existing data from cost of service studies, with costs for groups of component services allocated to specific components if need be;

2. the CPUC should direct utilities to undertake studies of costing and pricing of component services appropriate for the task of distribution function unbundling and possible competitive supply of some services,

particularly where the UDC might continue to provide the service to some customers at their choice:

a. utilities should provide proposals for these studies as an element of their ratesetting filings on November 15, 1996;

b. proposed studies should be reviewed, modified if need be, and utilities directed to implement them in a timely manner;

c. utilities should be directed to implement these studies as quickly as practicable. The results of these studies could be substituted for existing studies provided that the utility demonstrate that the use of the new results is in the public interest.

F. Feasibility of Using Information Developed by the Direct Access Working Group on Key Component Services

The Direct Access Working Group (DAWG) has investigated a substantial portion of the issues associated with distribution function unbundling, especially those portions described by SDG&E in Option 3 as "revenue cycle services." The DAWG report submitted August 30, 1996 provides in depth analyses of issues concerning metering, billing, and revenue processing activities. While not conclusive, the report provides a wealth of information about the possibilities for unbundling, and perhaps, allowing competitive supply of these services. Therefore, a good portion of the investigation implied by the CEC recommendation to pursue distribution function unbundling has already been begun by the DAWG. Rather than starting anew, the CPUC can build upon what has been accomplished by the DAWG.

IV. CRITIQUE OF OTHER OPTIONS

Options 1 and 2 share the feature that they insist that no distribution function unbundling be allowed by January 1, 1998. Option 2, however, recommends that the process to identify potential Track 2 services begin now, whereas Option 1 defers even the investigation until after January 1, 1998, and only if the CPUC makes further findings.

Options 3 and 5, along with Option 4, urge distribution function unbundling. However, neither Option 3 nor Option 5, propose development and implementation of a methodology that will ascertain the degree of unbundling and competitive supply of component services that is in the public interest. As set forth in the description of Option 4 in the Unbundling Report, the CEC proposes a process that will develop a methodology for unbundling, pricing, and modifying PBR incentives that will achieve the goals of Options 3, 4, and 5. Thus, we address only Options 1 and 2 in detail below.

A. Critique of Option 1

Option 1 is inconsistent with the Road Map Decision, D.96-03-022, and should be rejected. Edison, the proponent of Option 1, asserts that the work necessary to implement the "five consensus items" in advance of January 1, 1998 is so overwhelming that unbundling must be delayed. Edison cites the massive effort to create the ISO, PX and UDC, in addition to the rules for new market participants. Although the CEC recognizes that substantial resources must be devoted to the tasks that Edison identifies, utility resources currently devoted to other tasks could, and should, be made available for unbundling. For example, utility personnel who would participate in unbundling would likely be those devoted to cost of service studies, rate design, general rate case applications, rate design windows and Energy Cost Adjustment Account proceedings. Rather than delay unbundling, the CPUC should grant utility and intervenor groups burdened by excessive workload, relief from some of these traditional activities that may no longer be necessary in light of developing the

framework for the new paradigm. In addition, as suggested herein, unbundling can initially be based largely on existing data and analysis, thereby relieving parties from having to conduct new studies in advance of January 1, 1998. Thus, various aspects of the rate case plan discussed at the Scoping Workshop held by Commissioner Duque on May 20, should be reviewed once again, and all non-essential items dropped.

Unbundling to just the five "consensus" items is also inconsistent with the directive in the Final Policy Decision, D.95-12-063, that metering will be permitted by non-utility entities once appropriate metering standards have been developed. While proponents of Option 1 may assert that they do not wish to oppose distribution function unbundling permanently, the essence of Option 1 is to delay, for at least two years, efforts that have already begun.

B. Critique of Option 2

Like Option 1, Option 2 postpones actual implementation of distribution function unbundling until after January 1, 1998. Unlike Option 1, Option 2 would create a parallel process in which distribution function unbundling to identify "track 2" items would be pursued. The resources provided for this parallel process would be those "surplus" to those needed to be sure that the five consensus items were unbundled and implemented properly. No details of schedule or methodology are offered.

While there are some clear parallels between Option 2 and Options 3-5, the weakness of Option 2 is that it precludes any insights from the distribution function unbundling process from being implemented January 1, 1998. It would likely delay the actual date of implementation of such services, although, perhaps, not for as long as Option 1. Option 2 also fails to pursue the fundamental policy question of whether, or to what extent, distribution function unbundling is to be implemented in California. As such, it reflects the current ambiguity about fundamental CPUC policy and it retards

development of energy service providers that might only be viable when able to offer one or more distribution function component services to their customers.

V. THE RESTRUCTURING LEGISLATION

A. Key Provisions

Several provisions of AB 1890, the legislation that implements the market model described in the CPUC's Final Policy Decision, D.95-12-063, pertain to implementation of direct access and unbundling. Section 330 sets forth the legislative policy findings in support of the bill:

1. Subsection (d) cites the CPUC's finding that the interests of the ratepayer will be served by moving to a "framework under which competition would be allowed in the supply of electric power and customers would be allowed to have the right to choose their supplier of electric power."

2. Subsection (e) refers to the benefits of "competition in the electric generation market . . . ."

3. Subsection (f) provides that the "delivery of electricity over transmission and distribution systems is currently regulated, and will continue to be regulated . . . ."

4. Subsection (k) states that "competition in the electric generation market" will:

   (1) Separate monopoly utility transmission functions from competitive generation functions, through development of independent, third-party control of transmission access and pricing.

(2) Permit all customers to choose from among competing suppliers of electric power.

(3) Provide customers and suppliers with nondiscriminatory and comparable access to transmission services.

5. Subsection (l) cites several CPUC findings with approval, including the following:

(2) Generation of electricity should be open to competition . . . .

(4) [N]ew market institutions [i.e. the ISO and PX] should commence simultaneously with the phase-in of customer choice . . . no later than January 1, 1998.

6. Subsection (n) requires that "opportunities to acquire electric power in the competitive market" be available by January 1, 1998.

7. Subsection (r) provides that "transmission and distribution of electric power remain essential services imbued with the public interest . . . ."

8. Subsection (t) refers to "the transition to a competitive generation market . . . ."

Section 368 requires each utility to develop a cost recovery plan for the recovery of uneconomic costs through a CTC. Subsection (b) requires that each cost recovery plan

> provide for identification and separation of individual rate components such as charges for energy, transmission, distribution, public benefit programs, and recovery of uneconomic costs. The separation of rate components required by this subdivision shall be used to ensure that customers of the electrical corporation who become eligible to purchase electricity from suppliers other than the electrical corporation pay the same unbundled component charges, other than energy, a bundled service customer pays.

Section 368 continues, explaining that the purpose of the separation of individual rate components is to "prevent cost shifting among customer classes, rate schedules contract, or tariff options . . . ."

Section 392(c)(1) requires that certain information be supplied to customers and provides that electricity bills to consumers

> disclose each component of the electrical bill as follows:
>
> (A) The total charges associated with transmission and distribution, including that portion comprising the research, environmental, and low-income funds.
>
> (B) The total charges associated with generation, including the competition transition charge.

Finally, section 378 requires the CPUC to "authorize new optional rate schedules and tariffs, including new service offerings, that accurately reflect the loads, locations,

conditions of service, cost of service and market opportunities of customer classes and subclasses."

B. Unbundling Furthers the Goals of the Legislation

Option 4 furthers the policy goals of AB 1890 and is consistent with the relevant provisions. First, the legislation acknowledges the necessity for the separation of the five consensus items, i.e. Generation, Transmission, Distribution, the Competition Transition Charge (CTC), and Public Goods charges. The separation of these five items necessarily involves identification of services to be included in the five categories. Option 4 provides the methodology for accomplishing this objective. Further, the CEC strongly believes that those new products and services that must be developed in order to allow direct access should not be bundled into the distribution function. These new services can and should be unbundled, right from the start. Moreover, these are the services that will likely be considered as potential candidates for competitive supply in the future.

Second, the legislation expressly calls for "consumer choice." Consumer choice requires consumer options. In addition, the legislation favors that consumer choice be extended to all customer classes. Unbundling of certain intermediate services may be necessary to extend customer choice to residential and small commercial consumers.

Third, the separation of rate components required by § 368(b) is for the purpose of ensuring against cost-shifting among customer classes. It does not limit unbundling of the component services of the five consensus items. Finally, § 378 authorizes the CPUC to authorize "new optional rate schedules and tariffs, including new service offerings. . . ." Section 378 thus authorizes monopoly provision of unbundled intermediate services.

VI. CONCLUSION

For the foregoing reasons, the CEC urges the CPUC to adopt Option 4 and initiate the unbundling process as soon as possible.

Dated: September 12, 1996

Respectfully submitted,

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